

ANALYSIS OF ORIGINAL BILL

Author: Lewis and Schiff, et al. Analyst: Kristina North Bill Number: SB 1499

Related Bills: See Legislative History Telephone: 845-6978 Introduced Date: 02/05/98

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Gain From Sale of Principal Residence Exclusion

SUMMARY

Under the Personal Income Tax Law (PITL), this bill would exclude from gross income any income from the cancellation of secured indebtedness in the case of the sale of a taxpayer's principal residence.

EFFECTIVE DATE

This bill would be effective for taxable years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

SB 569 (1997)

SPECIFIC FINDINGS

For **federal and state tax** purposes, gross income generally includes income from whatever source derived, including gains from dealings in property. Gain in connection with the sale or exchange of property is the excess of the amount realized on the sale or exchange over the adjusted basis of the property. The amount realized from the sale or disposition of property is equal to the total of any money received plus the fair market value (FMV) of other property received.

A transfer of property by way of foreclosure or a deed in lieu of foreclosure is treated as a sale or exchange for income tax purposes. The amount realized in connection with the transfer of property by foreclosure or by a deed in lieu of foreclosure depends on the FMV of the property and whether the debt on the property is a recourse debt or a nonrecourse debt. A recourse debt is a debt for which the borrower is personally liable; a nonrecourse debt is a debt where the borrower is not personally liable.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

G. Alan Hunter

3/23/98

Agency Secretary

Date

By:

Date:

In any sale or exchange of property subject to nonrecourse indebtedness (including a foreclosure sale or a transfer by deed in lieu of foreclosure), the amount realized includes the face amount of the nonrecourse indebtedness. Consequently, the borrower will recognize gain to the extent the amount realized (including the full amount of the nonrecourse indebtedness) exceeds the adjusted basis of the property. The FMV of the property is irrelevant. In addition, the borrower will recognize no income from discharge of indebtedness.

In a sale or transfer of property subject to recourse indebtedness to a creditor (including a foreclosure sale or transfer by deed in lieu of foreclosure), the transaction is bifurcated into two transactions: 1) a sale or exchange of the property for its FMV; and 2) to the extent the FMV of the property is less than the outstanding recourse indebtedness, either a continuing obligation to pay or income from the discharge of indebtedness.

Indebtedness that appears on its face to be recourse may be treated as nonrecourse because of some provision of law. **Current state law** regarding real property prohibits a deficiency judgment in connection with indebtedness that was incurred to purchase a one-to-four-family residential property that is actually owner-occupied. Consequently, purchase money financing on one-to-four-family residential property that is owner-occupied is nonrecourse indebtedness, notwithstanding the owner-occupant's apparent liability for the indebtedness.

Current state law regarding real property also prohibits a deficiency judgment on seller-carried purchase money financing that is secured by an interest in the property sold. As a result, seller-carried indebtedness on any real property is nonrecourse.

For **federal and state tax purposes**, gross income generally includes income from whatever source derived, including income from discharge of indebtedness.

Current federal and state laws provide that gross income does not include income that would be includible by reason of discharge of indebtedness if, among other reasons, the discharge occurs in bankruptcy or the discharge occurs when the taxpayer is insolvent. Any exclusion from gross income requires a reduction in certain tax attributes of the taxpayer (such as net operating losses, certain tax credits, loss carryovers, basis reduction, etc.).

Under current federal law, to which **state law** conforms, a taxpayer generally may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years. Gain attributable to depreciation allowable with respect to the rental or business use of a principal residence after May 6, 1997, is not excludable. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for a cumulative period of two years during the five years prior to the sale or exchange.

This bill would exclude from gross income any income from the cancellation of secured indebtedness where a taxpayer's principal residence in this state is sold to a person holding a security interest in the residence.

As indicated above, cancellation of indebtedness income in connection with the sale of real property to the holder of a security interest in that real property only occurs when the indebtedness is considered recourse indebtedness. Consequently, the exclusion provided by the bill would be limited to income from the cancellation of indebtedness secured by an interest in a principal residence that was incurred for purposes other than to purchase an owner-occupied one-to-four residential property or from someone other than the seller of the residence.

Current federal and state laws provide an exclusion from gross income for discharge of indebtedness income that occurs in bankruptcy or when the taxpayer is insolvent. Therefore, the exclusion provided in this bill would be applicable in circumstances of discharge of indebtedness other than discharges in bankruptcy or discharges when the taxpayer is insolvent.

This bill defines "security interest" as an interest in a property created or established for the purpose of securing a loan or obligation, including mortgages, deeds of trust, liens, conditional sales, installment sales, or other transactions.

This bill defines "principal residence" as having the same meaning as used in the now repealed Internal Revenue Code (IRC) section 1034, which generally meant property owned by a taxpayer and used as the taxpayer's principal residence.

Policy Consideration

This bill would create a difference between the federal and state treatments of discharges of indebtedness, requiring an additional adjustment and adding additional complexity to the preparation of a California tax return.

Implementation Considerations

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- ◆ State law has conformed to the new federal law on exclusion from gain from the sale of a principal residence, including the definition of a "principal residence" as property owned by a taxpayer that was used as a principal residence for a two-year period during the five-year period preceding the sale of the property. The author may wish to change the reference to refer to current law.
- ◆ The author's office indicated the purpose of this bill is to allow a taxpayer selling a principal residence to a third party for less than the outstanding indebtedness (a short sale) to exclude from income the amounts realized from the discharge of indebtedness resulting from the sale. However, this bill does not include sales of principal residences to persons without a security interest and, consequently, would not include short sales.

- ◆ This bill does not specify the treatment of a sale between related parties or for mixed use property.

FISCAL IMPACT

Departmental Costs

With the implementation considerations unresolved, it is difficult to determine the department's costs.

Tax Revenue Estimate

Due to the complexities and inconsistencies noted below, it is not possible to quantify the impact of this bill. Revenue losses would be determined by (1) the number of qualifying transactions, (2) the amount of canceled debt otherwise included in gross income, and (3) the marginal tax rate of the taxpayers with these transactions. Neither taxpayers nor courts have treated qualifying transactions consistently. Data targeting qualifying transactions are not known to exist. In any given year, changing real estate market conditions and other economic conditions would influence the magnitude of potential losses.

The bill would be effective with sales occurring after December 31, 1997, with enactment assumed after June 30, 1998.

Tax Revenue Discussion

A qualifying transaction occurs when (1) a discharge of indebtedness occurs in connection with the transfer of a taxpayer's principal residence, (2) the residence is transferred to someone holding a security interest, (3) the recourse debt is formally discharged, and (4) the taxpayer is neither bankrupt nor insolvent. The excess of the obligation amount over the value of the principal residence transferred is the amount subject to the proposed exclusion under this bill.

The following two examples illustrate the revenue implications of qualifying transactions:

- ◆ A principal residence worth \$70,000 with an adjusted basis to the taxpayer of \$70,000, is transferred in satisfaction of a \$100,000 mortgage that is recourse. No gain is realized upon disposition of the residence because the value received in the transfer equals the basis. However, assuming the taxpayer has been discharged from \$30,000 of debt without payment, debt discharge income of \$30,000 would be recognized under current law and excluded under this bill.
- ◆ A principal residence worth \$90,000, with an adjusted basis to the taxpayer of \$70,000, is transferred in satisfaction of a \$100,000 mortgage that is recourse. Again, the debt discharge is separated from the capital gain or loss. The taxpayer would recognize \$10,000 of debt discharge income (excess of \$100,000 mortgage over value of residence given in payment) under current law and excluded under this bill. Also,

the taxpayer realizes \$20,000 of capital gain (excess of \$90,000 value received on disposition of the residence less \$70,000 basis).

In the case of nonrecourse indebtedness, a sale to the lender is treated as sale of property for the face amount of the debt and any additional money and property received by the seller. This approach results in \$30,000 of capital gain and no debt discharge income in both examples above.

In these examples, any realized capital gain on the sale of a principal residence may be excluded from income under current law if the ownership and use tests are met and the taxpayer is not ineligible for exclusion by virtue of a sale or exchange of a principal residence within the last two years.

BOARD POSITION

Pending.